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The length and severity of recessions depend partly on the magnitude of the "real" maladjustments which developed during the preceding boom and partly on aggravating monetary and credit factors — a scramble for liquidity by financial institutions as well as by others, destruction of bank money, and similar events on the international level.

***Prosperity and Depression*, Gottfried Haberler**
George Allen & Unwin Ltd., London, 1936

DOLLAR PUT BEATS GREENSPAN PUT

It seems a year of sliding stock prices and proliferating profit warnings has done little to dampen New Year cheer on and off Wall Street. While market watchers are not as giddy as they were last year, they are not at all scared. If the reports we have read in the press correctly express prevailing sentiment and expectation, investors have simply overreacted to some unexpected bad news about the economy. According to the comforting litany, the long-term growth and long-term prospects of the U.S. economy remain as stellar as they have proven to be in the past years. Why worry? All we need to stave off a recession, save the stock market and restore healthy profit growth are a few just-in-time rate cuts by Alan Greenspan, and perhaps the tax cut that George W. Bush has promised.

The talk on the Street for some time has been about the "Greenspan Put." This belief in risk-free U.S. financial markets entered the investment lexicon after the crisis from the collapse of the Long-Term Capital Management hedge fund in 1998. It implies that the Federal Reserve can be relied upon to come to the rescue of the economy and the markets in times of crisis by promptly pumping in liquidity and cutting interest rates, thus providing a floor to equity prices. This is similar to a put option that guarantees the investor a minimum price at which he can sell his shares. Belief that the put is again "in the money" was revived by Greenspan's speech on Dec. 5, which was quite clear in its upbeat message: *Count on me*.

Our message in this letter is of equal clarity: Don't count on Mr. Greenspan this time. His monetary easing in late 1998 and his following extremely hesitant rate hikes have precipitated the worst credit excesses ever in history, and in their wake caused economic and financial imbalances of unprecedented magnitude that have made the U.S. economy and its financial system extremely vulnerable to any economic slowdown. Furthermore, a collapsing dollar will seriously obstruct his policy stance.

After all, the U.S. economy is not just weakening, it is slumping with stunning speed. It would greatly surprise us if it shows any real growth in the fourth quarter. Stressing that it is a *bubble economy*, not a miraculous, new paradigm economy, we have warned many times that people will be surprised and shocked to discover how vulnerable and fragile the U.S. economy will prove once it begins to slow down.

All of a sudden, bad news is coming in rapid succession from all sides. For profits and profit expectations, it is a virtual free fall. Over the past few years, it had become the conventional wisdom that the Information Revolution had inherently liberated the U.S. economy from the scourge of old-fashioned recession. This new technology, according to the argument, is way too strategic an investment to be cut in response to a brief, cyclical downturn. Furthermore, the computer allows perfect monitoring of inventories, so production never gets too far ahead of sales, and the resulting combination of soaring productivity and intense competition keeps inflation in check, allowing the Fed to let growth roll yet keep interest rates rather low.

It happens that we are witnessing the diametric opposite. High tech is a disaster area both in the economy and in the stock market. The Internet it littered with companies that never made a profit and never will. The tech

segment of the S&P 500 index gained almost 100% from the beginning of 1999 until the market's peak on March 10. While the market valued these stocks at $1,400 billion at the time, they were accumulating $3 billion in collective losses.

The performance of the telecom giants appears hardly better. Their outstanding success so far, after the first euphoria, will cripple their balance sheets and destroy the savings of their investors. For those who believe that hubris is never that far ahead of nemesis, it's something to savor. There is far more in question for the U.S. economy than just the possibility of a conventional recession. At stake is whether the whole U.S. new paradigm economy has ever been for real or just a Wall Street hoax and marketing story.

THE KEY QUESTION

It all boils down to one key question: On what was America's "miraculous" boom of the past years, in fact, founded upon: the wonders of the new technology and new-style corporate management; or the most reckless money and credit creation that the world has ever seen, generating a grossly maladjusted bubble economy?

At issue is whether the Information Revolution, notwithstanding its fascinating technical achievements, may prove an outright economic flop. Having repeatedly explained why we think so, we continue to delve into this question of overriding importance. Watching the disastrous slide of the great bulk of Internet and telecom securities, both stocks and bonds, we think it ought to be realized that this is more than just a cyclical bear market. This is something secular, reflecting the utter failure of the New Economy to deliver appropriate profits.

One by one, high tech stocks and bonds are crashing to earth. Understandably, their unhappy owners cling to the hope that the technical "miracles," supposedly inherent to this technology, will not fail to deliver the promised economic miracles over time, bailing them out in the longer run. These hopes are grossly mistaken. There are compelling, specific reasons why this technology will forever remain of poor or non-existent profitability. The only real miracle is how Wall Street could so easily convince a gullible public that this technology is at all prone to deliver superior profits.

From what we see, the question is no longer whether the U.S. economy is in for a soft or a hard landing, but how steep and how severe the downside will be. The emerging data are showing a downturn that is snowballing across the whole economy with stunning speed. To quote the *Financial Times: "For companies that only a year ago were running production lines at full capacity, boasting about Internet-enabled inventory management and struggling to meet demand, the challenges of overcapacity, overgearing and overstocking have arrived with frightening suddenness."*

Each business cycle, of course, has its own strain of excesses and imbalances that eventually cause its demise. The most important thing to realize about the past American boom is that credit excesses of preposterous magnitude leave the U.S. economy with an array of huge, unsustainable economic and financial imbalances of which the negative personal savings rate, the monstrous current-account deficit and record-high debt levels in the private sector are only the most spectacular and most frightening ones. So far, fast economic growth and over-abundant availability of credit — also from abroad — have both obscured and papered over these imbalances, but sharply slowing economic growth is now unmasking them with a vengeance.

WHAT NEXT?

Ever since the stories about the U.S. economic miracles came into vogue, we have been expressing our doubts about their validity. Too many assertions appeared flagrantly incompatible to us. The profit miracle trumpeted by Wall Street was always clearly at loggerheads with the official National Income and Product Accounts data. Although everybody was aware of the conjuring trick with which analysts and corporations jointly misinformed the public, comparing reported, manipulated profits with expected, manipulated profits, nobody objected. And it is no secret that numerous American firms, in particular those in the high tech sector,

were heavily padding their earnings with windfalls from investment gains.

All of a sudden, profit warnings are the order of the day. Even though economic growth sharply slowed in the third quarter, it was still positive. Yet profits in the nonfinancial sector were down. The typical explanations are the weak euro and extraordinary competitive pressure. Considering that America's core inflation rate has risen by 0.6% to 2.6% over the past year, well above Europe's rate of 1.5%, we wonder about the reality of the "extraordinary competitive pressure." But what we wonder even more about is the compatibility of this poor profit performance with the reported, stellar productivity gains.

What next? Was the sudden weakness of the U.S. economy in the third quarter just a temporary, accidental blip? Or could it possibly be the beginning of something serious, perhaps very serious? Though the former, unbridled euphoria about the wonders of the new technology has faded, one cannot say that there is serious anxiety about the economy's further performance. Growth forecasts for 2001 remain remarkably bullish. The great majority of economists project 3% real GDP growth. Anything a bit less is extremely rare.

What is it that keeps economists and investment strategists so upbeat? According to *Business Week: "Most forecasters believe that the Federal Reserve will lower interest rates at some point in 2001. The move will be driven by a weak first half, they say. And thanks to the Fed's action, the economy will finish the year strong…Lower interest rates will more than offset the effects on stocks of a slowing economy and dwindling earnings growth.*" Putting it differently, the U.S. economy has no problems, except that interest rates are a bit too high, which Mr. Greenspan will, of course, promptly correct to the necessary lower levels. The consensus, in other words, trusts in the "Greenspan Put."

CRASHING CONSUMER SPENDING

Opposed to this general, complacent assessment, we said in the last letter that most probably the U.S. economy's hard landing has already arrived. This idea struck us for the first time when the Commerce Department originally announced stagnant real personal outlays for October, even though personal saving had slumped to a new record low of -0.7% of disposable income.

Meanwhile, the November figures have become available. When the Commerce Department released them on Dec. 22, commentators focused on a single number: a 0.4% increase in consumer income, uniformly hailing it as being in line with forecasts and expectations, and that was it. Looking at the Commerce Department's Web site as usual, we noticed a lot more: first, spending figures for October were revised upward, while income figures were revised downward. More importantly, both had substantially worsened in November.

As to the 0.4% income increase in November, it went unmentioned that this rate referred to personal income before taxes and inflation. After adjustment for the two factors, the impressive increase actually melts down to an insignificant 0.1%, following a decrease of 0.1% in October. We would qualify these two figures as shockingly bad. Nobody, though, took notice. The growth of private wage and salary disbursements, by the way, had virtually halved from $32.1 billion in October to $17 billion in November. Real consumer spending, on the other hand, which translates into corresponding real GDP growth, rose 0.1% in November, after (an upward revised) 0.2% in October. Together, the figures for the two months add up to 0.3% growth for two months, equalling 1.2% at annual rate. That was one-third of the 0.9% increase (3.6% at annual rate) in the first two months of the third quarter.

Trying to assess the prospects for further spending by the American consumer, it has to be realized that he is exposed to a savage financial squeeze, impacting him from three sides: *first*, abysmal growth of real disposable income; *second*, plunging financial wealth; and third, tightening credit conditions. Yet, he has not yet retrenched until quite recently. Given dwindling real income growth, his higher spending had to be increasingly matched by lower saving. During the six months to November 2000, he spent $79.8 billion in excess of his current income, as reflected in a steep decline of personal saving from $23.6 billion to –$56.2 billion.

To get a broad idea of what such sluggishness in consumer spending will do to the U.S. economy's growth performance in the fourth quarter, just look back at how much it contributed to third-quarter real GDP growth: Rising by 4.5%, it contributed 3.02 percentage points to the recorded real GDP growth of 2.2%, all at annualized rates.

CRASHING INVESTMENT SPENDING…

If consumer spending is falling flat, which other demand component could possibly take over as the economy's new engine? Essentially, this would have to be capital spending, exports or, even better, a mixture of the two. We read that capital-spending fundamentals remain firm, though less supportive than in 1999. Two ideas, above all, fuel the optimism about sustained capital spending: *first*, global and domestic competitive pressures and an ever-shortening product cycle will continue to compel firms to maintain high rates of capital spending for years to come, even if the economy slows; and *second*, the tightness of the labor market and the low cost of capital relative to that of labor still greatly favor the use of capital rather than labor, and thus stimulate investment spending.

It appears that these people have yet to notice that capital spending has crashed even faster than consumer spending, which, by the way, is the typical cyclical pattern. Here are the numbers for the three quarters of 2000.

UNITED STATES: REAL PRIVATE INVESTMENT

	INCREASE IN %*			CONTRIBUTION TO CHANGE IN REAL GDP**		
YEAR 2000	**I**	**II**	**III**	**I**	**II**	**III**
Fixed Investment	16.4	11.2	3.3	2.68	1.93	0.58
Nonresidential	21.0	14.6	7.3	2.54	1.87	1.04
Structures	22.3	4.4	14.9	0.63	0.14	0.46
Equipment	20.6	17.9	5.8	1.91	1.73	0.59
Residential	3.2	1.3	-10.5	0.14	0.06	-0.46
Inventories* **	36.6	78.6	73.5			

*at annual rate, ** in percentage points, *** in $billion

Source: Survey of Current Business, Department of Commerce

Looking at these figures, we cannot help but think that they look even more frightening than those for consumer spending. And importantly, this steep slide started in the first half of 2000, well before there were any signs of credit tightening and while all signs in the economy and in the markets still seemed to point to a continuing high-powered boom.

Again, the great question, of course, is: What is next? Could corporate capital investment possibly recover from this abrupt slowdown? All observations and considerations suggest the opposite: U.S. corporations are apparently coming under growing pressure from all sides to retrench their capital spending sharply, rather than mildly. We see that, *first*, cash flow is progressively falling behind capital expenditures, resulting in a record-high financing gap of about $220 billion at annualized rate in the second quarter; *second*, profit margins are dramatically worsening; *third*, both markets and banks are tightening credit; and *fourth*, massive mergers, acquisitions and stock buybacks have driven indebtedness to an unprecedented high.

Yet, one component in corporate capital spending has risen, even soared, in 2000. See the table above. Inventories have been mushrooming in the United States. This typically happens in an expansion's last quarter or two as sales fall short of expectations. Given the disappointing Christmas sales, inventories have certainly further increased in the fourth quarter. But to the extent that the new rise lags the sharp increase in the prior quarter, it correspondingly subtracts from GDP growth. Therefore, we assume that inventories will add to the weakness in the fourth quarter.

To return to our question at the start: What will happen to business capital spending? Looking at the dramatically deteriorating profit picture, the tightening credit condition and slumping consumer spending, it

becomes a compelling conclusion that capital spending will continue to slump across all categories: inventories, equipment and building.

…AND NO CHANCE FOR AN EXPORT BOOM

For some time, it was widely assumed that a slowing U.S. economy would get support through rising foreign demand, deriving from substantial growth acceleration in the rest of the world. It was always a fanciful perception because the Asian boom that started in 1998 got its chief fuel from an export boom to the United States. Somebody put it succinctly: The year 2001 is shaping up to be the year we had expected in 1999, after the Asian crisis. The rapidly weakening Asian economies were supposed to be laid flat by slowing demand in America. But the knockout blow from America never came. To the contrary, America sucked in a flood of imports that propelled a strong, albeit highly export-dependent, Asian recovery.

When the Fed decided in early October to maintain its policy bias toward fighting inflation, it relied partly on its staff forecast that the U.S. economy would get help from overseas to offset its slowing growth. The Fed believed that *"brisk growth abroad would boost the expansion of U.S. exports for some period ahead*." Just a month earlier, the International Monetary Fund had given the global economy a clean bill of health: *"Growth is projected to increase in all major regions of the world, led by the continued strength of the U.S. economy, the robust upswing in Europe, the consolidation of the upswing in Asia and the rebound from last year's slowdown in emerging markets*."

Even the economists at the top financial institutions tend to err alike. Not only that; they have erred out-and-out about the global economic development. With a suddenness that has taken policymakers, economists and corporate chieftains completely by surprise, all economies around the world are rapidly slowing in concert, most of all the U.S. economy. Prospects for a recovery in Japan have turned outright bleak. A new slide in stock prices threatens another possible fallout in the fragile financial sector.

Those most vulnerable to the effects of a hard landing in America are essentially the emerging economies because it was exports to the United States that have largely driven their recoveries. Asia is particularly dependent on exports of electronic equipment. Concerns over emerging economies are actually rising. Grossly overindebted Argentina and Turkey are struggling to service their debts, both needing huge IMF help. South Korea is being shaken by massive corporate bankruptcies and a badly weakened banking system.

EUROPE COMES INTO ITS OWN

Economic growth in the euro area is also past its peak, though still running at a respectable rate of close to 3%. Without question, Euroland's economy will be negatively affected by the economic slump in the United States and the emerging economies.

But it will be belatedly realized that Euroland's economy is definitely in excellent shape, and it is the most stable region in the world. Given a healthy trade balance and a much lower inflation rate than in the United States, Europe's central bank has incomparably greater scope to cut interest rates than America's and Japan's. America is lamentably weak on both accounts. The huge trade deficit, implying a heavy dependence on uninterrupted high capital inflows, makes it much harder for the Fed to cut interest rates. As for Japan, its interest rates are already close to zero. Importantly, too, Europe's economy is far less exposed to a crashing stock market than the U.S. economy because private households own far less stock than their American counterparts. No less importantly, Europe's economy is not beset by the horrendous economic and financial imbalances that afflict the U.S. economy as a legacy of the credit excesses that have accumulated during the boom years.

In light of these facts, we fully agree with a recent remark in the London *Economist* about an *"ugly duckling,*

called euro." It said: "*Europe's economic fundamentals are under-appreciated in the markets as much as America's are overblown.*" True, there is nothing spectacular about Europe's economy. However, it possesses something that the U.S. bubble economy has completely lost in the past years: internal and external economic and financial equilibrium. Private investment is fully covered by private saving, while government deficits have been sharply reduced. The net result is a balanced external current account. Europe has two major imbalances. One is a high, though lately declining, rate of unemployment, and the other a yawning deficit in its external capital account, due to large capital outflows. The plunging dollar is going to stop them virtually overnight.

There is a widespread view that a crash of the dollar, falling perhaps 40-50%, would immensely hurt the export-dependent European economy. We disagree. For sure, we expect the dollar to fall at least that much. And a euro that soars against the dollar and yen will hurt exports to these areas. But these negative effects on domestic income and purchasing power will be more than offset by the positive income effects from drastically cheaper dollar-denominated imports, which will also rapidly and spectacularly improve the euro area's trade balance.

SYSTEMATIC MISINFORMATION

Though weakness is rapidly spreading across the whole U.S. economy and its financial system, denial continues to reign supreme. The perception of the U.S. economy's superior qualities in terms of health, strength, efficiency and profitability, systematically built up over the past few years, appears untouched. The uniformly bullish growth forecasts for both the economy and the markets in 2001 speak for themselves. Any straw in the data that looks like good economic news is clutched at, while the rapidly growing amount of bad and very bad news finds only subdued and highly selective treatment in the media and the reports of banks and brokers.

What's more, economic reporting and commenting is grossly biased. It is by now blatantly clear that the U.S. economy is slowing much faster than Europe's economy. Consider that real GDP growth has decelerated from 7% in the second half of 1999 and 5.2% in the first half of 2000 to recently 2.2%, all at annual rates. Worse still, recent data suggest a strong chance of barely zero real growth or less in the fourth quarter. Yet, publicity centers on the slowing in Europe which may be from around 3.5% in 2000 to perhaps 3% or a little less in 2001. The other day, the *Wall Street Journal* carried a big headline on the first page: "Euroland Faces Threat Of Further Slowing." And why? Because — according to Mr. Greenspan — recent stock market declines and losses of asset values "could signal or precipitate an excessive softening in U.S. household and business spending." If this materializes, it would hit an already softening European economy, according to the article. What about worrying about the sharply slowing U.S. economy as an American problem in the first place?

The degree to which the public and the investment community are misinformed about the dramatically deteriorating economic and financial situation in the United States borders on fraud. We still wait to read someone reporting that, according to the government's NIPA accounts, profit growth of nonfinancial corporations crashed in the third quarter, actually decreasing 1.5%, after increasing 27.3% in the prior quarter. Or that corporate cash flow has plunged to $19.6 billion, from $35.3 billion in the second quarter. We still look for a report pointing out that U.S. capital spending, too, has crashed in the course of 2000, or that real consumer spending was virtually flat in October and November. If you know these and some other published, though generally ignored, facts, you know that the U.S. economy is heading for something quite frightening. As already mentioned: Denial reigns supreme.

TRAPPED

But why is U.S. consumer income growth suddenly so sluggish? Mainly for two reasons: *first*, suddenly slower consumer spending; and *second*, the soaring trade deficit. Growth in the consumer's income arises chiefly from his own spending, plus the spending of businesses on capital investment. Any slowdown in the two spending

components instantly translates into lower income growth. A growing trade deficit has the same effect by diverting domestic spending to foreign producers. Therefore, each additional dollar for imports is one dollar less for domestic consumer income and business profit. It goes without saying that such processes quickly become self-reinforcing, on the downside just as previously on the upside. If you look further at the open-ended paper wealth destruction in the stock market and the suddenly developing deadlock in the credit markets, you may understand our conclusion: The Day of Reckoning for the U.S. bubble economy is not on the horizon. It is here.

It is widely stressed as a great positive that consumer confidence, though somewhat down, remains high by historical standards, according to the Conference Board's index. Considering the multiplying profit warnings of Corporate America and the financial slaughter in the stock market, this apparent diffidence of the wider public may appear rather intriguing. Yet it isn't. It took more than a year after the crash in October-November 1929 for the public, at long last, to become frightened by the economic and financial developments. Then, as today, it has the same obvious explanation: The grossly inflated confidence built up over five boom years is highly resistant to bad news. But bear in mind, the higher the level of confidence, the steeper its later fall.

It has been asked why the violent Nasdaq slump and the associated heavy losses to investors have evoked so very little public outcry. We presume it is because most investors have simply not given up. Wall Street continues to feed them with forecasts of undiminished bullishness, and their fear of missing the next rally is greater than their fear of losing everything. Despite a year that turned into the decade's worst stock performance, it hasn't scared investors away. Just think of this: During this year of heavy wealth destruction in the stock market,American stock funds had their highest net inflow of funds ever, amounting to $300.54 billion until November. That was hugely in excess of the previous record year of 1997, when investors poured $227 billion into funds.

And far from worrying about weaker economic data, they continue to be hailed as tickets for the salutary soft landing that is supposed to warrant lower inflation and, above all, the lower interest rates that will re-ignite the accustomed bull market and recover the lost fortunes.

NO BOTTOM YET IN SIGHT

Earlier we asked: Was the U.S. new paradigm economy ever for real or just a Wall Street marketing story? For most people, to be sure, it is inconceivable that the New Era miracle stories about the U.S. economy were far more hollow hype than hard substance. Didn't even the venerated Maestro, Mr. Greenspan, again and again confirm these assertions? Besides, to give up hope and to realize losses is just too frightening a thought for many newcomers to the market. Some may comfort themselves by asking, how much further can a stock that is already down 90% fall? Unfortunately, it can fall another 90% and more even from there.

The fact is that high tech valuations, even at these shattered levels, remain sky-high by historical standards. Again, who is interested in pointing this out? It has come to us courtesy of Alan Abelson/George Gilman. On March 10, at the peak of the market, the Nasdaq index had an average P/E ratio of 240 times annual earnings. Even after their steep fall, the average P/E ratio of Nasdaq stocks is still well above 100. But please take into consideration that the profit picture is dramatically deteriorating, above all in the high tech sector.

Pondering the potential final effect of the ongoing stock losses on consumer spending, it is necessary to weigh two different trends. One is a drastic broadening of stock ownership among the American public in recent years; and the other one is a massive shift in personal holdings of financial assets away from risk-free assets (federally insured bank deposits and Treasuries) and toward ownership of illiquid stocks or stock mutual funds and lower-grade, high-yielding bonds.

Risk-free assets now account for just 20% of all financial assets held by private households, down from 50% in the mid-1980s. The share of household financial assets invested in directly-held corporate stocks and closed-end stock mutual funds, which was 28.5% in 1994, has soared to 53.7% in mid-2000 while the share of financial

assets held in bank deposits in these years has fallen from 22% to 17%. At the same time, total liabilities surged by 50% to presently about 100% of personal annual income.

DESPERADO, NOT MAESTRO

Mr. Greenspan keeps shocking us with his speeches qualifying him distinctly as the outstanding cheerleader for Wall Street's euphoria and the fabled "New Economy." Though his most recent speech on Dec. 5 in New York sounded rather minor in key compared to his customary hype, it still managed to implement another exuberant jump in share prices, lifting them by about $600 billion in a single day. The Nasdaq soared by over 10%, its biggest daily gain ever. Two remarks in this speech, in particular, caught the public's attention:

> *Our current conditions are in no way comparable to those of 1997-98. The palpable fears that dominated financial markets at the height of the crisis two years ago are not now in evidence. Financial markets continue to function reasonably well and credit continues to flow...*
>
> *In an economy that has already lost some momentum, one must remain alert to the possibility that greater caution and weakening asset values in financial markets could signal or precipitate an excessive softening in household and business spending.*

In essence, Mr. Greenspan's speech conveyed two reassuring messages: *first,* the economic and financial situation is not serious; and *second*, the Fed is ready to ease if the economy slows too much. Yet he also admonished that "*greater caution and weakening asset values could signal or precipitate an excessive softening in household and business spending.*" We can't remember hearing any warning from him that soaring asset values might precipitate excessive spending.

The most comforting thing he said, of course, was his comparison with 1998, when the three small rate cuts he implemented not only weathered the crisis, but ushered in the greatest boom of all time.

UNITED STATES: CREDIT EXPANSION, IN $BILLION (1996 - Q2 2000)

	1996	1997	1998	1999	2000 QI	2000 QII
Business	245.5	391.8	534.7	596.5	627.7	747.9
Private Households	347.6	333.4	480.5	543.4	531.4	635.4
Financial Sector	545.8	653.7	1073.9	1,087.9	618.3	842.9
Real GDP growth in %	3.6	4.4	4.4	4.2	4.8	5.6

Source: Federal Reserve, Flows of Funds Accounts

Looking at these numbers, you will notice that the American borrowing and lending binge collapsed into completely uncontrolled credit inflation in the course of 1998. This was well after the outbreak of the Asian crisis, which started in mid-1997. When the Fed cut its interest rates in late 1998 in the wake of the Russian/LTCM crisis, this credit explosion was already well on its way. It was to last until late 1999. The wildest excesses in the stock market, actually, were to follow in late 1999 and early 2000, when the Fed flooded the banking system anew with reserves, this time supposedly as a precautionary measure against the Millennium Bug.

But to unleash such monstrous credit excesses definitely needs more than just a reckless central bank. Above all it needs two conditions on the part of potential borrowers and lenders: *first, wildly inflated expectations of future prosperity; and second, a complete disregard of risk.* Lots of people have been at work generating this indispensable hype by blazoning all kinds of miracles happening to the U.S. economy. In this respect, one man has outdone all others — Mr. Greenspan. What's more, with his repeated, successful interventions in times of financial stress, especially the bailout of the insane LTCM hedge fund, he created a festering "moral hazard." After all, his name has become legend in the markets as the wise and all-powerful monetary Maestro. In the end, he only encouraged more and more reckless speculation and more and more risk-taking, inexorably making for his ultimate downfall. He will end up in the history books not as the Great Maestro, but as the Great Desperado among central bankers.

COMPARING 1997-98 AND 2000-01

Back to Mr. Greenspan's reassuring remark that, *"current conditions are in no way comparable to those of 1997-98,"* inherently implying that they are much better today. The extent of the financial damage at the time was portrayed vividly by William McDonough, head of the New York Fed, in his presentation at the IMF-World Bank meetings in September 1998. He statistically showed the sharp widening of credit quality spreads that had taken place in just a few months in three key sectors: mortgages, the emerging market and high-yield (junk) bonds. Yield spreads had widened even between newly issued and seasoned U.S. government bonds of nearly comparable maturity. McDonough emphasized that new-issue financing had virtually come to a halt and that some market makers were finding it difficult to finance their inventory. Overall market liquidity was drying up. This financial crisis, according to McDonough, had the potential to become the worst in the post-World War II period.

We fully agree that things are presently "*in no way comparable to those of 1997-98.*" But we draw the opposite conclusion: This time, they are much worse. There may be no single bomb of such ludicrous size as LTCM presently ticking in the U.S. financial system, yet it has become overall a lot more vulnerable. Financial leverage meanwhile has gone to new, preposterous extremes. Our simple measure for that is the surging excess of credit expansion to GDP growth. Most of that excess essentially goes into the financial markets.

Consider this brief comparison: Total outstanding debt of the nonfinancial sector during the two-year period after June 30 has risen $4,400 billion (20%). Corporate debt soared 30% to $4,600 billion, while private household debt increased 19% to $6,700 billion. This included a surge in outstanding mortgage debt by $1,600 billion, or 32%. And more specific to financial system leverage, the financial sector raised its borrowing by a whopping $2,000 billion, or 43%, to almost $8,000 billion.

Within the financial sector, security broker/dealers increased their total asset holdings by $270 billion, or 32%; finance companies by $265 billion, or 34%. And importantly, the government-sponsored enterprises boosted their asset holdings by an astounding $518 billion, or 44%.

In short, overall credit expanded $4,400 billion; the economy expanded $1,200 billion. Consider that the economy and the trade deficit absorbed at most $2,000 billion. Most of the credit expansion essentially went into financial leveraging, with the effect of grossly mispricing financial assets, including artificially low interest rates.

Looking at Sept. 30 data for Fannie Mae and Freddie Mac, for example, we notice that $33 billion of shareholder's equity now supports assets of $1,070 billion. Total assets since June 30, 1998 have ballooned by $507 billion (90%), while shareholder equity has increased $12 billion. In addition, they have guaranteed the "timely payment of principal and interest" on another $1,260 billion of mortgage-backed securities not held in their immense mortgage portfolios.

While Wall Street and Washington trumpet how wonderfully the "government-sponsored" financial institutions are managed, we share with other, more critical, observers the view that with implied government guarantees, aggressive use of derivatives and short-term financings, and historic balance sheet growth, these two institutions are the epitome of market distortions and bubble economics. Noticeably, they regularly expand their leverage aggressively during times of acute financial turbulence. In the last analysis, they have converted private mortgage debt into government debt at massive scale. Just as clearly, this has played a key role in lowering mortgage rates. When the credit market tightens, they step in and create liquidity. Just recently, Freddie Mac announced, "*it expects to issue $90 billion of U.S. dollar-denominated Reference Note and Bond debt in 2001, implying a 25% annual rate of growth.*"

THE TWO MOST IMPORTANT DIFFERENCES

In actual fact, we see several very important differences between the financial crisis of 1998 and that of

today. Principally, it is 1998 all over again. Then, however, it was panic and turmoil at the periphery of the global financial system that threatened the center, which appeared very vulnerable indeed. This time, in contrast, the developing financial crisis has its epicenter in the U.S. financial system itself. In essence, this means an entirely different scale of potential dislocations and a completely different ball game.

Earlier, we quoted New York Fed Chief McDonnough, describing the financial upheavals in the autumn of 1998. We have great difficulty reconciling those comments with Mr. Greenspan's comforting statement about the present situation. In any case, what we are presently observing is the beginning, not the height, of the crisis. Nonetheless, bad loans are already mushrooming at banks. Even gloomier are prospects in the corporate-debt markets with credit spreads at crisis levels. The implosion there has now sucked in the hitherto low-risk commercial-paper market, in which investment-grade companies do short-term borrowing. Spreads between blue-chip commercial paper have soared from 25 basis points in mid-November to around 100 basis points now.

By no means, though, is the technology sector alone in experiencing rapid financial deterioration. Quite ominous news is also coming out of the Old Economy. A sector to watch very closely is the automobile industry, having taken on fantastic debt loads to fund their captive finance companies. Even despite historically strong sales, their profits are deteriorating alarmingly. General Motors ended the third quarter of 2000 with total liabilities of $265 billion, compared to $214 billion two years ago, and shareholder's equity of $32 billion. In the case of Ford, the liabilities amounted to $263 billion, up from $204 billion two years ago, with shareholder's equity of $19 billion.

We come to a second, highly important difference between the crisis of 1997-98 and that of the present. Two years ago, the credit crunch developed solely in the capital markets, not on the part of the banks. Quite to the contrary, the banks regarded the seizure of the corporate bond market as an opportunity to expand their lending to businesses and consumers aggressively, as a result surging at double-digit rates. Conversely, in the early 1990s, when bad loans paralyzed banks and S&Ls, the buoyant credit markets readily stepped in as alternative major suppliers of credit. Now is the first time in many years that borrowers face an all-around credit crunch embracing the stock market, the corporate bond market and the banks.

Comparing today's situation with that in 1998, we see a third, probably the most important, difference. In 1997-98, the financial crisis and the associated monetary easing hit an American economy that was firing on all cylinders. This time, any easing will hit an economy that looks like it is plunging straight into recession, or something worse. During 1998, annualized quarterly real GDP growth rates ran in sequence: 6.5 – 2.9 – 3.4 – 5.6%. And 2000? After a strong start in the first half, the economy is suddenly slowing with a vengeance. Peaking at an annualized rate of 5.6% in Q2, real GDP growth plunged abruptly to 2.2% in Q3, its slowest gain in four years.

In hindsight, there can be no question that the Fed's easing in October-November 1998, occurring against the background of an already booming economy, was crucial in propelling the borrowing and spending excesses of private households and businesses to new outrageous extremes. Very few observers took notice. Ever since, Mr. Greenspan has enjoyed general applause and admiration for his prompt and highly effective action. It will be realized too late that the grossly inflated expectations and the preposterous economic and financial imbalances that he fostered with his reckless, monetary laxity — and also with his repeated, highly bullish utterances — have the potential to expose the U.S. economy to its worst crisis since the 1930s.

Imbalances are principally unsustainable. The imbalances that have accumulated in the U.S. economy during this bubble period are of monstrous magnitude. The collapse of personal saving into negative territory and the exploding trade deficit are only the most spectacular and the most threatening among them. That the two are interrelated goes without saying.

As already mentioned, it was in 1998 that everything, both the U.S. economy and its financial system, went completely out of control. Since that year's fourth quarter, personal saving has plunged from $244 billion to

recently –$56 billion. As for the U.S. current account deficit, it increased from $77 billion to $140.5 billion between 1990 and 1997. By the third quarter of 2000, it was running at an annual rate of $450 billion.

But now to another important question: What is it really that has broken the U.S. boom all of a sudden? The consensus readily ascribes it to the doubling of oil prices and to overkill by the Fed through its 1.75 percentage point increase in short-term interest rates. Obviously, it's a highly comforting explanation. Oil prices are already falling. More importantly, there is infinite faith that some rate cuts and liquidity injections by Mr. Greenspan will promptly halt the slide of the economy and the financial system toward debt implosion.

It is our firm conviction that the U.S. economy's sudden dive has very little to do with those rate hikes. Taking the prior rate cuts by 0.75 percentage points in late 1998 into account, the effective increase was in reality only 1%. That was less than the simultaneous rise in the inflation rate during this period from 1.6% to recently 3.4%. But above all, the unfolding credit explosion conspicuously testifies to the total absence of any credit restraint.

In our view, the U.S. economy's sharp downturn is basically a reaction to the unsustainable, preposterous credit and spending excesses that have accumulated during the boom. There essentially comes a point where such excesses simply exhaust themselves on their own and go into reverse, even in the absence of monetary tightness. It's an event that any smart central banker would try to avoid under all circumstances, because sooner or later the markets and the banks will do the tightening — despite him. Having abolished control during the boom, there is little chance to regain control during the crisis. After all, the markets and the banks in the United States are now tightening on their own.

Conspicuously, the American economy is weakening much faster than had generally been expected. Christmas sales are reported to have been the worst in a decade, making substantially negative growth in the fourth quarter highly probable. Yet from what we read and hear, the great sea change in market sentiment and expectations about the economy has definitely not yet occurred. Nevertheless, we are looking for it and the crash that it will trigger, in particular in the U.S. currency and the stock market.

WATCH THE DOLLAR

The question that is keeping us in high tension is: What will finally shatter the prevailing complacency? The first major crack, we expect, will happen when it definitely sinks in that American Christmas sales were very disappointing. A foreseeable traumatic shock is due at 8:30 a.m. on Jan. 31, when the Commerce Department will publish its first estimate of fourth-quarter GDP growth. What if it is zero or considerably less? Very few people seem to be prepared for this kind of message.

The other aggregate on which our eyes are closely fixed is the dollar. We regard the currency as the bellwether for coming trouble. A steep fall of the dollar against the euro poses the greatest single risk primarily to the U.S. financial system and from there to the economy. By braking new capital inflows, it will precipitate the dollar's decline. It amazes us how little attention this issue finds in the United States. Its fall against the euro by about 12% within just four weeks ought to have caused at least a little alarm. There has been little attention.

Policymakers in Europe and Japan are greatly worried that Mr. Greenspan will rather soon have to choose between lowering interest rates to support the economy and the financial markets or raising them in support of the dollar. It's the dilemma with which central banks of other countries are all too familiar. For the Fed, it would be a calamity that has never before been experienced. In the 1980s, when the European and Asian central banks despaired about the plunging dollar, James Baker, then Treasury Secretary, publicly scoffed to the foreign governments and central banks: The falling dollar is your problem, not ours.

Most American economists so far refuse to worry about this issue simply because they don't see a repetition of the dollar's steep fall in the 1980s. According to published surveys, hardly anyone sees a substantial further

rise of the euro from present levels. A lonely exception is the chief economist of Goldman Sachs, William Dudley. He sees the dollar against the euro at 1.27 by year-end. By the way, that's not far from the assumption that prevails in the European Commission and the European Central Bank. They like a stronger euro but are fearful of getting a lot more than they like.

Most American forecasters reject the possibility of a steady rise in the euro against the dollar. They argue that America's long-term structural growth rate remains higher than that in the euro area, and they have no doubt that Mr. Greenspan will quickly rekindle this rate of growth. Although the euro may briefly rise against the dollar, they believe it will fall again as the U.S. economy bounces back.

As for ourselves, we have no doubt that we shall soon be faced with the worst dollar crisis of all times, sending it to unprecedented lows against the European currencies. And what's more, we expect it to happen with stunning speed, confronting the Fed dramatically with the dilemma either to support the economy by slashing interest rates or to support the dollar by raising interest rates. In our view, the Fed will be forced to compromise between the two, doing too little for the one and too little the other, that is to say for the economy as well as for the dollar, and together, this is bound to play havoc with the financial markets.

In other words, the famous "Greenspan Put" won't work as smoothly as in the past. But that's only one aspect that leads us to the conclusion that the U.S. economy and its financial system are heading for their worst crisis in the postwar period. The crux of the matter is the same one that economists have argued about in connection with the Great Depression. Was it due to Fed policy mistakes in these years that could have been easily corrected by more monetary ease — or was it the inevitable consequence of the prior inflationary boom? We have always believed in the latter. Comparing the two periods, however, we realize two very important differences that make the present U.S. economic and financial situation the far more frightening of the two. One is that the excesses and imbalances of the 1990s vastly exceed those of the 1920s; and the other one is that the heavy dependence of the U.S. economy and its financial system on sustained, huge capital inflows to finance the monstrous trade deficit seriously limit the scope for monetary easing.

CONCLUSIONS:

Rather sooner than later the markets will critically re-examine the euphoric perceptions of the U.S. economy and the status of the currency. There will be a rude awakening. We see an incredibly vulnerable dollar and we would interpret the Fed rate cut as a sign of desperation.

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